DOW THEORY LETTERS INC.

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THE MARKET: In reading over the many investment services which arrive here each week, I am amazed by the three or four soothsayers who are always absolutely certain about the situation. The actual fact is that despite glowing news it has been a year since the last high in the Rail Average and five months since the last high in Industrials. This allows room for at least a flitting shadow of doubt; not so for the purveyers of certainty. They have the answer to the market at any hour of the day or night, and if they are wrong — well, this is a fast changing business. "Quackery," wrote Robert Rhea in 1934, "can usually be detected by positiveness of pronouncements." A year later Rhea noted: "Those who try to profit by the advance and decline of security prices are perplexed perhaps 90% of the time, and it seems that perplexity increases with experience. It has seemed to this writer that unvarying cocksureness on the part of traders and investment advisors is a badge of incompetence."

Recent market action has provided far more than the usual quota of drama. For instance, the week ending October 1 produced 42.4 million shares of volume, making it the second largest volume week in Exchange history. On both September 28 and 29 the hourly intra-day tabulations for the Industrial and Rail Averages showed these two indicators above their 1965 highs of 939.62 and 224.91 respectively. Yet by the close on September 28, Industrials were off 2.08, Rails off .28. September 29 produced another morning rally, but again the market drifted off at the close, this time producing losses of 3.46 and .86 respectively. September 30 provided a repeat performance, with the decline ending abruptly the next day (October 1).

A new rally began on October 4 (Monday), and on October 5 (Chart 1) the two Averages pushed above the September highs to within fractions of their bull market peaks. Interestingly, a number of leading averages have already recorded all-time highs, among them the Standard & Poor "500," the S & P 425 Industrial Average and the D-J 65 Stock Average. Such action, in the normal course of events, has usually been bullish, and it is certain that many traders have already "jumped the gun" and purchased shares for the long-predicted "breakthrough" by the Dow Jones Average to new highs.

On October 5 Industrials closed at 938.70 (92¢ under their all-time high). On the same day Rails closed at 224.63 (just 28¢ under their all-time high). This closing placed the two Averages within fractions of reconfirming a primary bull trend. To add to the drama and perplexity of the situation, on the afternoon of October 5 it was announced that President Johnson was to undergo an operation for the removal of his gall bladder.

The announcement immediately brought a number of questions to mind. How would this news affect the market? The operation was not supposed to be a serious one, and it was probable that a strong market could rise in spite of the unexpected news. Yet the operation news was big enough so that it could also supply "the excuse" if the market wanted to go down.

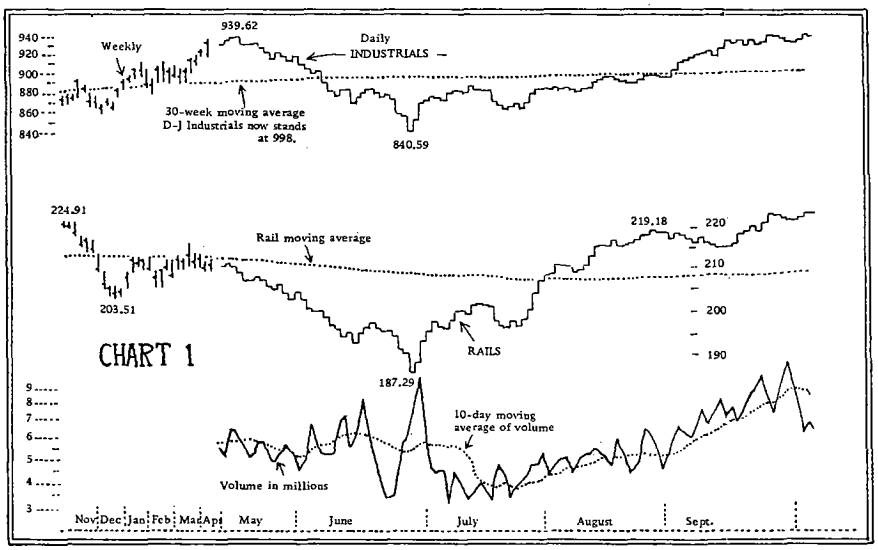
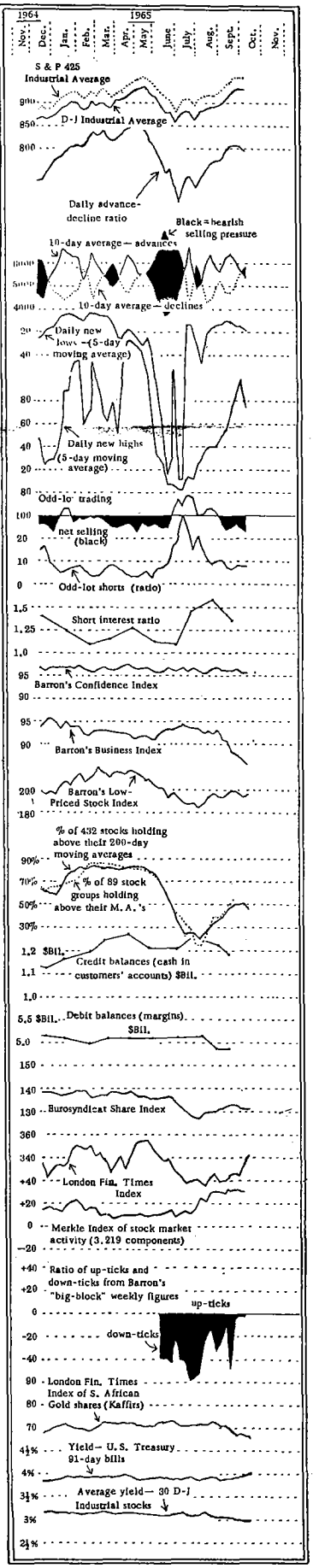
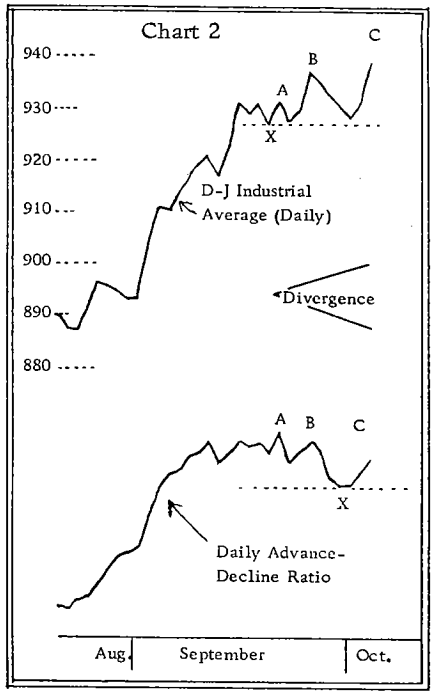


CHART 1


1964
1965
Nov. Dec. Jan. Feb. Mar. Apr. May June July Aug. Sept. Oct. Nov.
S & P 425 Industrial Average
D-J Industrial Average
Daily advance-decline ratio
Black = bearish selling pressure
10-day average — advances
10-day average — declines
Daily new lows (5-day moving average)
Daily new highs (5-day moving average)
Odd-lot trading
net selling (black)
Odd-lot shorts (ratio)
Short interest ratio
Barron's Confidence Index
Barron's Business Index
Barron's Low-Priced Stock Index
% of 432 stocks holding above their 200-day moving averages
% of 89 stock groups holding above their M.A.'s
Credit balances (cash in customers' accounts) $Bil.
Debit balances (margins) $Bil.
Burosyndicat Share Index
London Fin. Times Index
Merkle Index of stock market activity (3,219 components)
Ratio of up-ticks and down-ticks from Barron's "big-block" weekly figures
up-ticks
down-ticks
London Fin. Times Index of S. African Gold shares (Kaffirs)
Yield — U.S. Treasury 91-day bills
Average yield — 30 D-J Industrial stocks

Was it significant that the Averages had stopped just short of new highs on October 5? They could have as easily risen to new highs that day, and new highs prior to any "scare decline" would look better than a drop which might occur with the Averages having failed first to record new highs.

Is there any historical example of a market "topping out" on bad news, or is the old adage "never sell on the news" a correct one? In August, 1937, the Industrial Average (following a decline) had returned to within 2 points of its March bull market peak. Then came the news of the sinking of the U. S. gunboat "Panay" in China. Those who would not sell on the news lost heavily, for the bear market was ready to begin in earnest with or without the Panay, and in the next six months the Dow cut itself in half. Was the Panay "the trigger" which set off the drop or was the market ready to collapse anyway? We will never know.



Another coincidence has occurred to complicate the situation at this writing. Chart 2 depicts the relationship between the Industrial Average and the daily advance-decline ratio from late August to October 5, 1965. This is a situation familiar to veteran readers of these Letters. It is a picture of a potential "triple divergence" between the A-D ratio and the Dow. Note that both the Dow and the Ratio touched peaks on September 22 ("A" on chart). A slight recession occurred, followed by a new peak on the Dow on September 27 (937.88 at "B" on chart). But at B the A-D ratio did not confirm. Another decline ensued, and on October 5 the Dow climbed to a third new high at "C". Again the A-D ratio refused to confirm. This is the formula which has, in the past, preceded many important drops. Any decline which would take the two indicators below their recent trading range lows at "X" on the chart would signal the completion of this potentially bearish divergence. Conversely, a rise by both components to new highs would have the effect of erasing the potential divergence. At any rate, I thought it was extraordinary that this structure should appear at this particular time. (It is worth noting that the appearance of a potential triple divergence as shown on Chart 2 has, in the past, often been a signal for an extended parting of the ways between breadth or the majority of issues and the Industrial Average).

On September 16 the Industrial Average climbed above the 930 level for the first time on the recovery. The senior Average has been within 1% of that level ever since, and 116 million shares of stock has changed hands (an average of 7.7 million shares per day). This is a lot of steam under the boiler with little movement so far, and it can be regarded as "churning." Nevertheless, many churning markets have been resolved on the upside. A bettering of the previous highs by both Averages will suggest that the recent area was one of accumulation, and that the stronger buyers have been swapping cash for the stock certificates of weaker sellers.

We read much about what Dow Theorists "will do" if the two Averages better their bull market highs. According to a number of uninformed writers, Dow Theorists will immediately "load up" if the two Averages push above the 939.62 and 224.91 level. But this is a mistaken notion. If the bull market is reconfirmed, this writer will be inclined to remember that it is late, very late in the game, and that each successive upward penetration in a bull market has less validity than the last. Since trading is a difficult game I will not be apt to play this market on the upside, even if the two Averages rally to new highs from here.

The Composite Chart (Page 1) shows the two leading industrial averages in the vincinity of their record May highs (actually the S & P average has bettered its May high while the Dow has yet to match this performance). The A-D ratio continues its sluggish performance of the past five weeks, but is still well under its May peak. The 10-day averages of advances and declines are practically in equilibrium, with a very mild area of selling pressure appearing last week. Daily new highs (5-day av.) have drifted back to the 70 area, while new lows have crept up to 20. Odd-lots continue their steady selling, suggesting a persistent unwillingness by the public to "grab the bait." The short interest ratio is becoming a neutral to even negative factor because of the recent huge volume, and I calculate that the ratio could drop to the 1.0 area this month (anything under 1.0 is "thin ice" for this indicator). The percentage of stocks holding above their moving averages retreated to 46% last week, after pushing above the 50% level during the previous week for the first time on the whole recovery movement. Big blocks showed minus 5 for the week ending September 27, thus remaining in negative territory. The London market rose to 340 last week while the S. African golds sank to 65.7, and it seems clear that there will be no move in golds until London runs into trouble again. The negative spread of 1% between Treasury bill yields (which advanced to a five year high of 4.05% last week) and the yield on the D-J Industrial Average (2.99%) remains in effect. Sensing the tightening in the money market, the never-identified "high Administration officials" announced last week that no tightening in interest rates is warranted at this time. Presumably, the "statement" was aimed at the banks.

Conclusion: The short-term story will be told by the ability or inability of the Averages to better the May highs (939.62 and 224.91). For the long-term investor, the picture is a sobering one, and this writer has advocated a move into as liquid a position as possible (this means a 10 to 15% gold hedge with the rest of your assets in 91-day U. S. Treasury bills).

CREDIT NOTES: Two of the men who watch market and bank credit statistics are anything but happy about the way the picture is developing. From an October 2 (personal) letter from Dr. Sloan Wilson (publisher of Mission Market Musings, 5618 West 62 St., Shawnee Mission, Kansas): "This is one of the most dangerous markets I have seen. The retracement has taken place without an increase in Brokers' Loans in N.Y.C., and with only a negligible advance in the Debit Balance and the Member Borrowings. And the Odd-lot Dollar Figures show that the odd-lotter is running scared, and this is not a good sign at this point in the market. It would seem that this advance had the benefit of what one might term 'clean' (new) money. Where has it come from? It certainly does not seem to be knowledgeable money."

From A. Hamilton Bolton's latest October issue of the Bolton-Tremblay Bank Credit Analyst: "A review of banking and credit indicators shows the continuation of deterioration on a slow dragging scale, such as we have had over the last few months. In addition, we are now moving for the first time since 1959 towards a liquidity shortage to add to the unfavorable implications of the spending/debt accumulation cycle. Its contours are not yet defined but the statistics are moving rapidly in that direction." Later Mr. Bolton notes: "While 3-month totals of Spending have been quite strong, the latest month's figures (August) were actually down about 3% from July and were under June also, which was the peak month of the year so far. Commercial and Industrial loans, however, continued to forge ahead, and at the end of August were at the highest point in the postwar period. Since the beginning of 1965, these loans have risen a whopping 12½%. At this level of the debt structure no economy can stand such a sharp increase in loans, especially in view of the fact that spending figures have not been able to make comparable gains." (For a discussion of Bolton's Debit/Loan Ratio, see the last Letter).

VOLUME: The "bullishness" of the record September N.Y.S.E. volume has been almost unanimously acclaimed by market analysts. The theory is that most bull markets have produced two price-volume peaks, with the second (higher) price peak usually being recorded on lower volume. Thus, it is reasoned, the September volume was highly bullish since regardless of possible temporary weakness, we can expect another higher price peak ahead. If this second price peak is recorded on lower volume we will then have cause for alarm.

This theory is certainly logical, and the only possible fault is this — it is predicated on the definite view that we are still in a bull market. But a few of us still remember that the Dow Theory did render a bear signal in June, and unless or until both Averages better their 1965 highs, orthodox Dow Theorists will maintain that a bear market is still in effect. Now here is an interesting thesis which must be on the minds of all who follow the Dow Theory (in honesty, I must say that only one analyst has noted this or seen fit to put it in writing; this was Mr. A. Hamilton Bolton): Suppose, for the sake of argument, that we are still in a bear market, and that this recovery is a particularly powerful and deceptive secondary

MONEY MARKETS: There are two great dramas going on in the financial world today. The first is obvious, it is the surging churning action on the N.Y.S.E. The second is less conspicuous, but it is just as dramatic — the battle of the money markets. Here are some of the factors involved in the money battle.

U. S. corporations are stepping up their investments in Europe. But due to pressure from the Administration (balance-of-payments considerations), these corporations are now borrowing heavily not in the U. S. but in European markets. This is keeping European money rates high; in some cases it is even driving them higher. European bonds from such leading nations as Germany, France and the Netherlands are already yielding 5.75 to 7%, and there is little chance that these rates will come down. The result is a wide disparity between yields on U. S. and comparable foreign bonds. This disparity is siphoning off dollars to Europe and is exerting pressure on U. S. Treasury bonds (see Letter 300). Last week, for instance, the entire U. S. Treasury bond list sagged badly with many yields rising to 4.33%, and the bellwether 4 1/4's of 1987-92 (issued in 1962) broke below 99 for the first time since issuance. At current yields, many Treasury bonds are beginning to compete with deposits in banks and savings and loans.

Perhaps more dramatic was the rise in 91-day Treasury bill yields last week to the 4.05% level, highest yield since March, 1960. This means that the bills now yield more than the interest rate (4%) at California banks (for savings). The bills are also now above the 4% bank discount rate, and this has in the past often been a signal for a rise in the discount rate. Certificates of deposit in many leading banks have recently been raised to 4½%, which means that the C. D.'s are and will be competing directly for corporate money which would normally go into Treasury bills. Other bank news is that at least two leading banks have raised minimum interest rates ¼% to 4 3/4% on loans to finance and other credit companies. This will have the effect of raising consumer financing rates. Many banks are waiting to see whether President Johnson's wrath will be incurred by recent developments; if not it will probably be the signal for further rate increases among banks and lending institutions across the nation.

The insatiable appetite for new money has also produced other unusual effects in our money markets. Business is now absorbing bank credit and investment money which had formerly been going into state and local bonds. As a result, municipal bond yields (tax free) have been climbing (see Letter 301). Secondly, the advantage of mortgages over bonds is now disappearing with the result that large institutions which normally buy mortgages are becoming less interested.

Finally, aggravating the situation is the fact that lending institutions are now liquidating part of their bond portfolios in an effort to supply money to their business customers, and this means both a lack of bidders on new bonds and a steady pressure in the Treasury market as these bond portfolios are reduced (often at substantial losses).

Conclusion: No let up in the trend towards tighter money. What would cause a let-up? A downturn in business and an accompanying drying up in demand for money.

* * *

The forces of world deflation and inflation are confronting each other directly now. The problem was touched upon in the last Letter. The 60 or so "underdeveloped nations" are running a whopping deficit annually (about $10 billion), and the U. S. is no longer able to finance the deficit which up to now has supplied most of the dollars with which these underdeveloped nations operated. That is why the U. S., after defending the world monetary system for years, has reversed itself and proclaimed the need for "world monetary reform."

But monetary reform, as far as the U. S. is concerned, means developing a new currency, and one of the bases of that currency is to be gold and currency of the various "rich" European nations. Unfortunately, the European nations, the "have's" with the gold, are not particularly interested in parting with their hoards of yellow metal. Most of them, as a matter of fact, would like to build up their gold reserves even further. An example of the hard European attitude was provided at the I. M. F. meeting by Carl Blessing, President of West Germany's Bundesbank: "....in my opinion a sustained improvement in the balance-of-payments situation of the U. S. and the U. K. is of greater importance than all the efforts to reform the international payments system." In so saying, Germany has sided with France in the hard money-soft money argument.

So the problem smoulders; the U. S. is committed to reducing its deficits and thereby reducing the outflow of dollars. The alternative would be a new currency with a portion of European gold as its base. Europe, possessing more gold than the U. S., is now in the driver's seat (as nations with gold always are). Most European countries have had disastrous experiences with inflation and they are more afraid of inflation than they are of, for instance, some of the underdeveloped nations going bankrupt. What is the answer to this problem? It could boil down to a question of which comes first, the Great Society or the dollar.

upward reaction within that bear market. If that theory proves ultimately to be correct, then what we have seen is a "double top" on huge volume. And in fact, the massive September volume would have represented distribution, not accumulation as has been generally suggested.

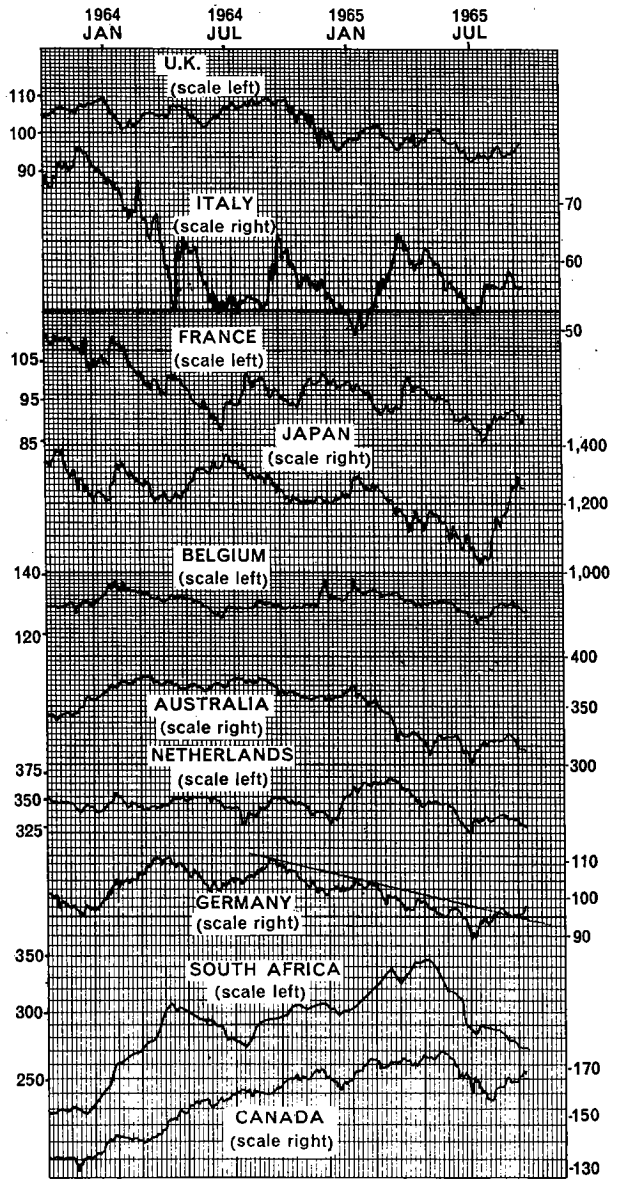
Is there any precedent for such action? Yes, as Bolton noted and as I have mentioned many times before, there is the classic example of Spring, 1930 (following the crash of 1929). Here is Robert Rhea's description of the electrifying 1930 upward correction: "I can remember having shorted stocks in December, 1929, after having completed a satisfactory short position in October. When the slow but steady advance of January and February carried above the previous high, I became panicky and covered at considerable loss. With losses piling up every day, I forgot that the rally might normally be expected to retrace possibly 66% or more of the 1929 downswing. Nearly everyone was proclaiming a new bull market. Services were extremely bullish, and the upside volume was running higher than at the peak in 1929."

Conclusion: From the standpoint of Dow Theory, no one can yet prove that the market action of July to September, 1965, is fundamentally any different than the action which occurred during the Spring of 1930.

CONFIDENCE, ANYONE? A subscriber asks me what "a contrary opinion for 1966 might be?" I leave it to readers, in view of the following two comments. The University of Michigan's Institute for Social Research reports that U. S. consumers are "confident and optimistic" about the future of the economy. According to the leading economist and the director of the Michigan survey, "The expectation of a recession is now less common than at any time during the past 15 years."

Meanwhile, in a report to the annual meeting of the National Association of Business Economists in Chicago, seven possible economic problems were assessed in order of importance. While 23% of the economists were worried about inflation only 4% (the last on the list) were worried about recession.

FOREIGN MARKETS: I last reviewed foreign markets in Letter 296. The accompanying chart (courtesy of International Investor, 50 Denmark Hill, London, S. E. 5) will bring this important study up to date. The only hopeful profiles at present are those of Japan and Germany. The former has rallied back to its January level, following a flood of liquidation and bankruptcies which has to some extent "cleansed" the air. Japan is in an all-out export drive, and this low-cost producing country is giving Europe and the U. S. rugged competition. Germany, another tough exporter, has improved its stock showing, and on the chart we see the German stock average bettering a long declining trendline. South Africa has sustained a vicious decline, partly due to the government's clamp-down in an effort to improve its balance-of-payments. In general, none of these indices are near their bull market highs. The U. S. alone, due in large part to a massive inflation of the money supply, has kept its stock market near the bull market high.



STOCKS: Chartcraft (Larchmont, N.Y.) lists the following as the five strongest stock groups: (1) Radio-TV Mfgs. (2) Savings & Loan Holding Co.'s (3) Electronic Leaders, (4) Air Transport, (5) Sulphur Producers. The five weakest groups are (85) Food Chains, (86) Biscuit Bakers, (87) Cigar Mfg.'s, (88) Finance Co.'s, (89) Brewers.

Chartcraft notes that only 31 of their 89 Groups (35%) are now acting better than the S & P 500 Stock Average. This is an extremely low percentage, and it points up an interesting facet of the current Wall Street situation. There are a great many crosscurrents within Groups and within individual stocks at this time. Few Groups are now exhibiting broad strength among their individual components. Thus, in a given group made up of say 10 individual stocks, five of those stocks may be strong, while five may be weak. This results in a desultory performance for the group as a whole, and this is the reason why only 35% of the groups are now outperforming the S & P 500 Stock Average. When strength is broad, the total Group showing improves. The above study jibes with the percentage of stocks holding above their moving averages as seen on the Composite Chart (Page 1). Here again, despite many spectacular performances by individual stocks we note that only 46% of all stocks are even holding above their 30-week moving averages.